

Broadband providers to be squeezed by the NBN - Retail plan prices to rise or NBNCo and Turnbull take a write-down



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In its November Investor Day presentation Telstra made the stunning statement that it believes that 80% of the network capacity that would be required in 2020 has not yet been built!

Data consumption is skyrocketing with the growth of online streaming of entertainment through devices such as smart TV's.

Streaming of Netflix for example is understood to account for 35% of downloads in the US and is growing rapidly in Australia.

On the surface it might seem that this trend is very positive for internet service providers (ISP's) such as Telstra and TPG (which also owns iinet), but it's not.

The NBN is now rolling out rapidly and is impacting the profitability of these companies, albeit in different ways.

Telstra is losing its monopoly on fixed line infrastructure with its old copper network being sold to NBNCo and will be placed on a level playing field as all other providers as a reseller of NBN access.

For TPG the infrastructure that it (and iinet) has placed in exchanges around the country will become redundant and the margin that it receives on reselling NBN access vs the old ADSL access will be significantly lower.

To understand this requires an understanding of the way that NBNCo will charge. In simplistic terms there are two main components.

The first is a monthly fee per subscriber tiered to the download/upload speed that we each select. The most popular are summarised in this table.

Upload/ Download Speed (Mbps)	Monthly Wholesale Charge (per user)
12/1	\$24.00
25/5	\$27.00
100/40	\$38.00

The second is a fee for the quantity of bandwidth that an ISP purchases. This could also be described as the proportion of the fibre cable capacity that is purchased.

The current fee is \$15.75 per Mbps per month net of a rebate.

ISPs do not buy the full amount to supply us each a guaranteed speed of 12/1 or 25/5 per month. If they did the fee to provide a 12 Mbps upload speed would be \$189 per month.

This is obviously prohibitive and would be wasteful as much of the bandwidth in the network lays idle for much of the day.

To manage this ISPs spread the bandwidth across their subscribers. At present average provisioning of bandwidth is around 0.8 Mbps per month for retail customers.

This explains why we get much slower speeds at peak periods than the headline speeds that our plans promise. We are all competing for a portion of this bandwidth.

Putting all this together ISPs are currently paying NBNCo \$36.60 per subscriber for a 12/1 plan. Additionally they have the costs of running their business, and taxes to pay including GST. This leaves profit margin as low as \$8 per month from the \$60 they receive on a 12/1 plan.

And this will get tighter if our data consumption keeps growing and ISPs need to buy more bandwidth and are unable to pass the cost of this on to us.

Telstra have guided that 2015 EBITDA will be impacted by \$2bn to \$3bn, or 18% to 28% by the NBN.

It's not all bad news for Telstra though. It is expected to receive \$11bn in payments for the sale of its copper to NBNCo and there is the possibility that this will be higher. It has also identified some significant cost savings and mobile network investments to offset some of this impact, and there is good growth potential in other parts of its business.

TPG's profit might be impacted by around 25%. It also has some levers to pull and will survive as a second largest player with real scale. Potentially it could benefit by picking up customers from Telstra as the NBN creates a significant customer churn event.

There is a risk though that competition from smaller players, which the NBN was meant to promote, may diminish.

For the government this poses a political challenge that places it between a rock and a hard place.

If it does not change the current fee structure, either the service that we get from the NBN will not meet our expectations or the price that we pay will have to go up considerably. Either way voters will be unhappy.

If it does reduce fees to the benefit of ISPs then NBNCo may need to write-down the value of its assets, which would in-effect result in a loss of tax payer funds. The Government may also need to provide additional support as this revenue is required to fund the ongoing rollout of the network.

Clearly none of these outcomes are politically palatable particularly given that Malcom Turnbull was the Communications Minister who revamped the NBN.

Whilst it is easy to see knives coming out, the reality is that the Government is doing the best it can with a project that it inherited.

It was always going to cost more to build a broadband network in Australia given our vast geography and a relatively small population to support this cost.

We are not likely to know what possible changes there could be to NBNCo's charges until the ACCC has completed a review later in 2017.

At least until then a cautious approach should be taken to investing in the telcos. **E**